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Nos. 87-453 and 87-464

In The

Supreme Court of the United States

October Term, 1988

Amerada Hess Corporation, et al.,

Appellants,

v.

Director, Division of Taxation,

Appellee.

Texaco Inc. and Tenneco Oil Company,

Appellants,

v.

Director, Division of Taxation,
New Jersey Department of the Treasury,

Appellee.

On Appeals from the Supreme Court of New Jersey

BRIEF OF AMICI CURIAE IN SUPPORT OF THE APPELLEE BY THE STATE OF IOWA, AND THE STATES OF CALIFORNIA, FLORIDA, GEORGIA, IDAHO, MICHIGAN, MONTANA, NEW YORK, NORTH DAKOTA, RHODE ISLAND, SOUTH CAROLINA AND WYOMING

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INTEREST OF AMICI CURIAE

Pursuant to United States Supreme Court Rule 36, the signatory States submit this Brief as Amici Curiae in support of the Appellee. Since this Brief is sponsored and filed by the aforementioned States, consent to its filing is not required. United States Supreme Court Rule 36.4.

Some of the Amici States have significant oil production while others have little or none. Some of the Amici States disallow a deduction for the windfall profit tax in the calculation of the State unitary net income base subject to apportionment. Others allow the WPT as a deduction. All Amici States employ the unitary business principle in connection with their State taxes measured by net income upon corporations.

All of the Amici States share a common concern which has led to the filing of this Brief. Amici are concerned that Appellants' position that there is an inherent geographic skewing of the unitary net income base in this case unduly encroaches upon State use of the unitary business principle. Amici strongly believe that a disallowance of a cost, such as the WPT, in calculating net income is related to the profitability of the unitary business as a whole. To say otherwise, as Appellants do with their argument that an inevitable geographic imbalance occurs, would erode the States' ability to exercise a reasonable discretion in defining a unitary net income base. Appellants' position is a blatant attempt to convince this Court to sanction a separate accounting inroad to the unitary business principle.

ARGUMENT

I. DENIAL OF WPT AS DEDUCTION IN CALCULATING APPORTIONED STATE TAX ON OR MEASURED BY NET INCOME DOES NOT INHERENTLY RESULT IN EXTRATERRITORIAL TAXATION IN VIOLATION OF THE DUE PROCESS CLAUSE AND THE COMMERCE CLAUSE.

Appellants make two basic arguments in this phase of their Appeal. First, they contend that the New Jersey Corporation Business Tax (CBT), by disallowing the federal windfall profit tax (WPT) as a deduction, creates a geographic bias in the preapportionment net income base so that the resulting apportionment will unreasonably attribute net income to New Jersey. They claim that such geographic imbalances must occur when the unitary net income base includes receipts from the entire unitary business but not all related costs, such as the WPT, which they claim are incurred only outside the taxing State. Second, they contend that the disallowance effectively imposes the CBT as a windfall profit tax upon oil production outside the State. The Solicitor General has filed a brief in which he states that the New Jersey CBT raises substantial federal questions with respect to denial of a WPT deduction.

A. A Nonproducing State's Disallowance Of WPT As A Deduction In Calculating A Unitary Tax Base Composed Of Net Income Does Not Create An Inherent Geographic Bias In Favor Of The Nonproducing State.

Appellants assume that the WPT is a site-specific cost having nothing to do with New Jersey where no oil is

produced. They argue that the CBT cannot constitutionally disallow the WPT as a deduction because there is no comparable in-State outlay for which deduction is disallowed in computing the CBT. "A taxing jurisdiction is free to permit or deny deductions for such geographically dispersed costs without risk of creating an inherently asymmetrical tax base." (Appellants' Brief at 22).

Amici contend that the alleged geographical bias is contrived by Appellants. The application of the unitary business principle effectively bars Appellants' extraterritorial taxation claims. In any event, a portion of windfall profit is likely, as a matter of economic substance, to be incurred in New Jersey so as to justify the WPT deduction disallowance under Appellants' theory of deduction disallowance for geographically dispersed costs.

1. Appellants' Claim Of Geographic Bias Is Contradicted By The Unitary Business Principle.

The unitary business/formula apportionment method "calculates the local tax base by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 165 (1983). Although not unfettered, the States possess great leeway,

both in their definition of the scope of the unitary business and in their choice of the apportionment formula. *Container*, 463 U.S. at 164, 167.

The unitary net income base may include only unitary operating net income of a single corporation, *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920), may include unitary operating net income and unitary investment net income of a single corporation, *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), or may include the unitary net income of all corporate affiliated members of the unitary enterprise, *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). In addition, the factor or factors in the apportionment formula selected by the States need not be uniform among the States. *Moorman Manufacturing Company v. Bair*, 437 U.S. 267, 278-280 (1978). Thus, a State may select from a variety of methods to calculate the unitary net income base or the apportionment formula, notwithstanding that these methods inevitably attribute different increments of income to the same income producing activities in the State. These inevitable differences have not, by themselves, been held by this Court to result in extraterritorial taxation.

Given that the unitary net income base subject to apportionment need not be uniformly computed, it follows that the States have great leeway in their definition of "net income" which constitutes that base. Indeed, in *Atlantic Coast Line Railroad Company v. Daughton*, 262 U.S. 413, 422, n. 6 (1923), the Supreme Court observed with respect to the makeup of the "net income" of a multistate enterprise:

> The term 'net income' in law or in economics has not a rigid meaning. Every income tax act necessarily defines what is included in gross income; what deductions are to be made from the gross to ascertain net income; and what part, if any, of the net income, is exempt from taxation. These details are largely a matter of governmental policy. As to them states differ; and there is apt to be difference of view in the same states at different times; and at the same time a different definition of taxable net income for different classes of taxpayers. Obviously, such differences in detail do not render obnoxious to the commerce clause a state income tax which is otherwise unobjectionable.

Appellants, being unitary businesses, are unable to demonstrate the precise sources of their net incomes which are earned as a result of "functional integration, centralization of management, and economies of scale" which are "factors of profitability" that "arise from the operation of the business as a whole." *Mobil Oil*, 445 U.S. at 438; *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 222 (1980). Therefore, attempts to match any cost solely with a particular portion of a unitary business run the risk of ignoring or capturing "inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container*, 463 U.S. at 164-5.

Three cases run counter to Appellants' site-specific economic theory that the WPT must inherently be allowed by a nonproduction State as a deduction in determining net income of a unitary business to avoid a geographic distortion of the tax base. In each case, this Court rejected taxpayer arguments of unconstitutional

extraterritorial taxation and, instead, indicated a wide leeway of tolerance for apportioned State taxes.

In *Moorman Manufacturing Company v. Bair,* 437 U.S. 267 (1978), this Court held that the Iowa single factor sales formula did not inherently result in extraterritorial taxation, even though that formula did not include the property and labor of the taxpayer, whose Iowa activities consisted of marketing its products which it manufactured outside the State. The rationale in *Moorman* will not support an argument that there is an inherent malapportionment of net income associated with the taxpayer's in-State activities merely because the manufacturing components, although included in the net income base as deductions, for example, depreciation and payroll expense, are not included as property and payroll factors in the apportionment formula. In addition, this Court noted the divergence in the definition of "nonbusiness income." 437 U.S. at 279. By analogy, it cannot be said that a definition of net income which does not allow a deduction of the WPT expense which is incurred by the unitary business, so that it is functionally related to activities in the taxing State and elsewhere, violates the Constitution by resulting in inherent extraterritorial taxation.

In *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983), the taxpayer, in arguing against an income apportionment upon a combined report basis which included net income from foreign subsidiaries, asserted that lower wages in foreign countries lead to lower costs of production there so that the standard three factor formula, which included wages, caused a geographical bias that unreasonably increased income attributable to taxpayer's operations in the taxing

State. The taxpayer's evidence demonstrated such disparity in wage rates and, further, that the lower foreign wages were not balanced by lower foreign productivity levels. The Supreme Court rejected the argument that the application of the standard three factor formula, under these circumstances, created a geographical bias and distorted result. This Court stated in 463 U.S. at 182:

> The problem with all this evidence, however, is that it does not by itself come close to impeaching the basic rationale behind the three-factor formula. Appellant and its foreign subsidiaries have been determined to be a unitary business. It therefore may well be that in addition to the foreign payroll going into the production of any given corrugated container by a foreign subsidiary, there is also California payroll, as well as other California factors, contributing – albeit more indirectly – to the same production.

In *Exxon Corp. v. Wisconsin Dept. of Revenue,* 447 U.S. 207 (1980), the taxpayer alleged that its vertically integrated oil business was subject to invalid extraterritorial taxation by the taxing State of Wisconsin in which no oil was produced. This Court rejected that allegation and found a proper relationship "between the income attributed to the State by the apportionment formula and the intrastate value of the business." 447 U.S. at 227. In *Exxon,* the taxpayer argued that Wisconsin was imposing its tax upon the taxpayer's production income that occurred wholly outside the State. This Court rejected that argument and treated the production activities as contributing to the profitability of the whole unitary business. Likewise, the WPT is associated with the profitability of the entire unitary business. Therefore, *Exxon* forecloses Appellants' argument that a disallowance of a

deduction, even if constituting an out-of-State cost, inherently results in extraterritorial taxation.

In the instant case, the alleged geographical distortion caused by New Jersey's refusal to allow Appellants to deduct their WPT in the calculation of their unitary net income bases is speculative. Since States are not rigidly required to define a unitary net income base in a manner which allows all costs to be deductible, New Jersey's refusal to authorize deduction of taxes imposed upon income or profits is a perfectly reasonable exercise of the State's power to define its tax policy. To say otherwise would be to introduce into the calculation of a unitary net income base a rigidity that would not be warranted. New Jersey has imposed a tax that, for all the record in the instant case shows, is imposed upon "a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." *Moorman*, 437 U.S. at 273.

The importance to income production of each factor in the three factor property-payroll-sales formula is by no means ascertainable, so that giving each factor equal weight is "arbitrary." *Container*, 463 U.S. at 184, n. 20. Indeed, it may very well be that the New Jersey market place was "responsible for the lion's share of the income generated by" sales of Appellants' products in New Jersey. *Moorman*, 437 U.S. at 272. Certainly, nothing in the record in this case disproves this potential fact and, if it exists, there would be no geographical bias even if Appellants' theory as to the site-specific source of the WPT had some merit.

Appellants' geographical bias argument ignores the function of the unitary business/formula apportionment method which is an attempt to value the income producing activities of the unitary business in the taxing State. This attempt passes constitutional muster as long as it produces a result that is "reasonably related to the activities conducted within the taxing State." *Moorman*, 437 U.S. at 273. In this regard, Appellants, in arguing that the New Jersey failure to authorize a deduction of WPT inherently results in extraterritorial taxation, seek to prevail where previous State income tax litigants have invariably lost. This Court has never held that a State income tax unitary business/formula apportionment method will *always* result in malapportionment. By contrast, this Court has made clear that Appellants' unproven and speculative allegation is not enough to show extraterritorial overreaching. *Moorman*, 437 U.S. at 272.

Instead, while overreaching has been occasionally found in the *application* of the unitary method, *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931), the taxpayer has the heavy burden of showing by clear and cogent evidence that an unreasonable apportionment or geographical bias has occurred in the application of that method. *Container*, 463 U.S. at 164; *Moorman*, 437 U.S. at 274.

In the instant case, there is no "clear and cogent evidence" that New Jersey's failure to allow WPT as a deduction in calculating net income has resulted in an improper skewing of the value of Appellants' income

producing activities in that State. The New Jersey decision to exclude the WPT as an allowable deduction cannot support any assumption of unconstitutional geographic bias in State taxation, regardless whether Appellants' position has merit "from the standpoint of economic theory or legislative policy." *Moorman*, 437 U.S. at 272. Therefore, even if the WPT were not imposed upon an activity in New Jersey, there is no evidence in this case that New Jersey's refusal to authorize it as a deduction automatically causes extraterritorial taxation of Appellants' income.

2. The WPT And The Windfall Profit Are Directly Associated With Appellants' Marketing Activities In New Jersey.

The WPT is a tax on additional or anticipated profits which were expected to accrue to the oil producers as a result of decontrol of oil prices. In *United States v. Ptasynoski*, 462 U.S. 74, 75-6 (1983), this Court stated:

> During the 1970's the Executive Branch regulated the price of domestic crude oil. See HR Rep. No. 96-304, pp. 4-5 (1979). Depending on its vintage and type, oil was divided into differing classes or tiers and assigned a corresponding ceiling price. Initially, there were only two tiers, a lower tier for "old oil" and an upper tier for new production. As the regulatory framework developed, new classes of oil were recognized.
>
> In 1979, President Carter announced a program to remove price controls from domestic oil by September 30, 1981. See id., at 5. By eliminating price controls, the President sought to encourage exploration for new oil and to increase production of old oil from marginally economic operations. See HR Doc. No. 96-107, p. 2 (1979). He recognized, however, that deregulating oil prices would produce substantial gains (referred to as "windfalls") for some producers.

> The price of oil on the world market had risen markedly, and it was anticipated that deregulating the price of oil already in production would allow domestic producers to receive prices far in excess of their initial estimates. See ibid. *Accordingly, the President proposed that Congress place an excise tax on the additional revenue resulting from decontrol.*
>
> Congress responded by enacting the Crude Oil Windfall Profit Tax Act of 1980, 94 Stat. 229, 26 USC § 4986 et. seq. (1976 ed, Supp V) [26 USCS §§ 4986 et. seq.]. The act divides domestic crude oil into three tiers and establishes an adjusted base price and a tax rate for each tier. See §§ 4986, 4989, and 4991. The base prices generally reflect the selling price of particular categories of oil under price controls, and the tax rates vary according to the vintage and types of oil included in each tier. . . .

(Emphasis supplied).

The Senate Report, concerning the proposed Windfall Profit Tax Act, stated that the "committee believes that the large price increases on previously discovered oil resulting from phased decontrol are an appropriate object of taxation." S.Rep.No.394,96th Cong.,2nd Sess.6 (1979). The House Report concurred by stating that "[t]he committee believes that there should be a tax on the windfall from decontrol of crude oil prices and from excessive increases in world prices." H.R.Rep.No.304,96th Cong.,2nd Sess.4 (1979).

The WPT is a tax "imposed on the windfall profit from taxable crude oil removed from the premises during each taxable period." 26 U.S.C. § 4986(a). The WPT is "paid by the producer of the crude oil." 26 U.S.C. § 4986(b).

The amount of WPT is imposed with respect to the windfall profit for each "barrel of taxable crude oil." 26

U.S.C. § 4987(a). There are three tiers of oil subject to the WPT upon the windfall profit per barrel of integrated oil companies and each tier has a different tax rate known as "applicable percentage." 26 U.S.C. § 4987(b).

The "windfall profit" is calculated by subtracting from the "removal price" of a barrel of crude oil the "adjusted base price" and the "severance tax adjustment" with respect to that barrel. 26 U.S.C. § 4988(a). The "removal price" of a barrel of oil is either its actual sales price to third parties or a constructive sales price determined under 26 U.S.C. § 613. 26 U.S.C. § 4988(c). The "adjusted base price" of a barrel of oil is its base price multiplied by an inflation adjustment. 26 U.S.C. § 4989. In determining the "windfall profit" of a barrel of oil, the WPT Act provides that such "windfall profit" cannot be in excess of "90 percent of the net income attributable to such barrel." 26 U.S.C. § 4988(b).

Structurally, the Congress opted to impose the WPT upon a windfall profit per barrel of crude oil using in the windfall profit calculation a "removal price" that was either its actual sales price or its constructive sales price. Obviously, integrated oil producers, such as Appellants, who remove crude oil for sale off the production premises or who manufacture or refine products from their extracted crude oil, whether on or off the production premises, have not yet, by the mere act of "removal", recognized any profits or revenues as a result of decontrol of oil prices. That recognition will occur upon actual sale of the crude oil or the refined and manufactured oil products to third parties. The production activity is merely one in a series of activities whereby the unitary business actually earns the windfall profit that is subject to the WPT.

The integrated oil producers transfer (remove) crude oil from the production site to downstream facilities where the oil is commingled with oil from other sources, thereby making it impossible to trace any particular per barrel windfall profit. However, when oil or oil products emerge from downstream facilities and are sold in States, such as New Jersey, it is reasonable to assume that the artificially incurred windfall profit taxed by the WPT Act upon "removal" is now realized and is earned, in part, by the integrated producers' marketing activities in the States where sold. Accordingly, the economic reality or practical effect is that the windfall profit, resulting from oil price decontrol, is earned, due to the unitary nature of the business, "by a series of transactions beginning with the [exploration and extraction of oil outside the State] and ending in sales in [New Jersey] and other places." *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 282 (1924); *see Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980).

It is reasonable to assume that some windfall profit must be associated with sales of Appellants' oil products in New Jersey. But, it is impossible to ascertain the amount thereof due to commingling of oil so that the per barrel windfall profit cannot be traced to specific barrels of oil that were consumed in the refining and manufacturing of products sold in New Jersey.[1] However, the fact

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[1]It is possible that some oil products sold in New Jersey were refined from oil which was not associated with WPT, either because the per barrel calculation was such that no windfall profit was incurred or because the oil was exempt from the WPT, for example, oil from sources outside the United States or oil exempt under 26 U.S.C. § 4991(b).

that Appellants, as integrated producer-marketers, market oil products in New Jersey assures that some windfall profit is included in the sales prices of the refined oil products and, as a result of their unitary business, is earned in part in New Jersey.

When Appellants' oil products are marketed in New Jersey, one must assume that windfall profit is included in the sales prices of such products. While Appellants emphasize that the WPT is due upon "removal" even if the oil is lost or otherwise never sold, the economic reality remains that the WPT was imposed upon the anticipated decontrolled revenues, in part due to Appellants' sales activities in New Jersey and elsewhere. The structural form of the WPT should not disguise the practical substance that there is likely to be actual windfall profit earned, in part, from Appellants' activities in New Jersey. It is unlikely that significant amounts of oil will be lost or otherwise unsold. The "practical effect" of the New Jersey CBT is controlling in this case. *Exxon*, 447 U.S. at 227-8.

For the WPT to be solely a site-specific cost, all windfall profit must have accrued at the production site. While windfall profit, namely, the additional revenue from decontrol, may be site-specific if the crude oil is sold to third parties at the production site, such site-specificity does not occur where the integrated oil producers remove crude oil to downstream facilities, as Appellants for the most part did. Under those circumstances, while the windfall profit is superficially deemed by Congress to occur upon "removal" at the production site, the windfall profit, in fact, cannot be deemed to solely accrue there. The windfall profit will accrue, in part, as a result of Appellants' marketing activities of their oil products in New Jersey and elsewhere wherein they sell those products which they refined and manufactured from their extracted oil. Since the windfall profit, therefore, did not accrue solely at the production site and at least a portion of it accrued from marketing activities in New Jersey where higher prices as a result of decontrol were obtained, the WPT imposed upon that geographically dispersed windfall profit would not be sourced solely to the production site. In practical effect, the WPT geographically follows the windfall profit. Accordingly, by Appellants' own geographically dispersed costs test for State discretion to permit or deny deductions without creating an inherent geographic imbalance, (Appellants' Brief at 22), no such imbalance exists in this case.

B. Disallowance Of A Deduction For The WPT Does Not Operate As A Tax On the Removal Of Crude Oil From Out-Of-State Premises And Does Not Violate The Nexus And Fair Relationship Standards.

1. Appellants claim that disallowing a deduction from the New Jersey CBT base for the federal WPT is the same as imposing a New Jersey windfall profit tax on the out-of-State removal of oil. They claim that because New Jersey has no nexus with the out-of-State removal of oil, the disallowance of the deduction violates the nexus prong of the test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

Disallowing a deduction, however, is not the equivalent of imposing a tax. For example, if no deduction from the income tax base is allowed for sales tax, the state has not created another sales tax. If no deduction is allowed

for property tax, the State has not imposed a tax on the taxpayer's property. If no deduction is allowed for a severance tax, the State has not imposed a tax on severance.

Deductions are a matter of grace and a form of subsidy administered through the tax system which the legislature can disallow as it chooses. *Regan v. Taxation With Representation*, 461 U.S. 540, 544, 549 (1983). A State is not required to allow deductions for expenses of doing business, regardless of where those expenses may be incurred. This includes tax expenses such as the WPT. "Income", for State income tax purposes, need not be the net income left for the use and enjoyment of the taxpayer.

New Jersey in no way imposes a severance tax on out-of-State severance. Liability for the New Jersey CBT is not based upon the amount of oil removed from the ground or the value of the oil. The apportionment formula does not apportion barrels of oil to New Jersey. It apportions income. That income base may include a unitary business' total income. *Exxon Corp.*, 447 U.S. at 223. That total income may constitutionally be the income prior to payment of certain expenses, including the WPT expense.

Appellants argue that disallowing a deduction for the WPT acts as a severance tax because the WPT is a severance tax. The WPT is not a severance tax, however. It is a tax on income or profits. *Tenneco West, Inc. v. Marathon Oil Co.*, 756 F.2d 769, 772-73 (9th Cir. 1985); *Crocker National Bank v. McFarland Energy, Inc.*, 140 Cal. App. 3d 6, 189 Cal. Rptr. 302 (2d Dist. 1983). The WPT is imposed upon excess revenue realized as a result of

decontrol. *Tenneco West*, 756 F.2d at 773. The fact that liability for the tax is triggered by removal of the oil does not make it a tax on removal. It is the vintage and type of oil, and other factors specified in the Act, that determine whether WPT is due. *Id.*[2]

As previously discussed, the windfall profit is earned, in part, as a result of Appellants' New Jersey marketing activities. There is no violation of the nexus standard where New Jersey's CBT disallows as a deduction a cost, such as the WPT, which is associated with windfall profit activities in that State.

2. Appellants further argue that disallowing a deduction from the New Jersey CBT base for the WPT violates the fair relationship requirement of the *Complete Auto Transit* test. They claim that New Jersey is imposing a tax whose measure is a percentage of the value of the crude oil produced in another state, thereby bearing no relationship to the taxpayers' presence or activities in the State.

Appellants' claim is groundless. The measure of the New Jersey CBT remains *income*, with certain deductions allowed. Since income results when the oil is sold, the measure of the tax is related to Appellants' marketing activities in New Jersey. Appellants pay income tax to

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[2]The fact that some members of Congress may have characterized the WPT as a severance tax is irrelevant, especially since other members recognized the WPT as being a tax on profits. *See* 125 Cong. Rec. H17141 (Remarks of Rep. Lederer); 125 Cong. Rec. H17142 (Remarks of Rep. Shannon); 125 Cong. Rec. H17151 (Remarks of Rep. Ullman).

New Jersey not because of out-of-State oil production but because of their sales activities in New Jersey. In connection with those activities, New Jersey does afford protection and opportunities. Indeed, Appellants' marketing of oil is an integral part of their unitary businesses, important to assure full use of their production and refining operations. *See Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 225-26 (1980).[3]

When a tax is assessed in proportion to a taxpayer's activities or presence in New Jersey, the taxpayer is shouldering its fair share of supporting the State's provision of police and fire protection services, a trained work force, and the advantages of a civilized society. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 627 (1981). Those advantages constitute a long list, including such things as the maintenance of means of transportation and the various amenities which encourage the use and consumption of the products which directly add to Appellants' wealth.

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[3]Appellants erroneously assert that the increased value of crude oil due to decontrol bears no relationship to the producer's presence or activities in New Jersey. (Appellants' Brief at 40). Without a market for the oil, however, the oil would have no value. The presence of a New Jersey market for the oil affects the oil's value, including the value after decontrol. Therefore, the increased value of oil due to decontrol is directly related to the producers' activities in New Jersey.

In addition, as discussed, *supra*, at pp. 10-15, the windfall profit (and the WPT) are directly associated with New Jersey activities. The practical effect of the CBT, in disallowing a WPT deduction, is consistent with this association.

Appellants fail to prove that the disallowance of a WPT deduction causes the New Jersey income tax to be grossly out of proportion to the services provided by New Jersey. This is especially true since New Jersey could constitutionally tax Appellants' New Jersey gross receipts, which may well be a much larger tax base than is the New Jersey net income base after apportionment. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978); *see Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 227 (1980).

II. DISALLOWANCE OF A DEDUCTION FOR THE WPT FROM THE CBT BASE DOES NOT IMPERMISSIBLY DISCRIMINATE IN VIOLATION OF THE COMMERCE CLAUSE OR THE EQUAL PROTECTION CLAUSE.

Appellants claim that the disallowance of a deduction for the WPT violates the Commerce Clause and the Equal Protection Clause because it imposes on crude oil production activities, which occur outside of New Jersey, a discriminatorily higher effective tax burden than that imposed on in-State business activities. This claim is unsupported by any comparison between similarly situated taxpayers or between comparable in-State and out-of-State activities or taxpayers.

A. The New Jersey CBT Does Not Impermissibly Discriminate Against Out-Of-State Business Operations, But Properly Treats Producers Differently Than Non-Producers.

Appellants are treated the same, for New Jersey CBT purposes, as are all other corporations that pay the WPT. They are not discriminated against in favor of other *similarly situated* taxpayers. Producer-marketers of petroleum are in fact different from nonproducer-marketers, as one

group directly benefited by the decontrol of oil prices and one did not. Producer-marketers of petroleum received the benefits of decontrol and higher oil prices which gave rise to the windfall profits taxed by the federal government. Nonproducer-marketers did not receive the benefits of decontrol (since they had to purchase their oil at the inflated prices) and accordingly paid no WPT. A State legislature could reasonably conclude that corporations paying WPT were in a better position to pay additional state CBT due to their receipt of substantial windfall profits which remained with these corporations even after payment of the WPT. *See* H.R.Rep.No.304,96th Cong.,2d Sess.72 (1979) (46 percent of unearned profits left with oil producers).

Different businesses may be taxed on different bases without violating the equal protection clause. The legislature may define "net income" as it sees fit as long as the statute has a rational relationship to the legitimate legislative purpose being accomplished. *See Atlantic Coast Line Railroad Co. v. Daughton*, 262 U.S. 413, 423-25 (1923). It has already been established that corporations receiving the windfall profits from oil price decontrol are sufficiently different from corporations who did not benefit from decontrol to warrant different tax treatment. Producer-marketers may constitutionally be classified differently from other marketers of petroleum products. A state legislature could reasonably conclude that producer-marketers' "corporate organization and the magnitude of their operations in every aspect of the petroleum industry, from the well to the gasoline pump, afforded [them] a

market power and economic advantage over their [non-producer-marketing] competitors and special opportunities to obtain the benefit of the conditions existing in the world-wide market." *Shell Oil Co. v. New York State Tax Com'n*, 91 A.D.2d 81, 458 N.Y.S.2d 938, 943 (1983). "The equal protection clause does not prevent a state from taxing such economic power and competitive advantages." *Id.*

B. Disallowance Of A Deduction For The WPT Does Not Discriminate Against Interstate Commerce Because It Does Not Favor Any Comparable In-State Activity Or Taxpayer.

1. Appellants agree that in disallowing a deduction for the WPT the New Jersey CBT does not favor New Jersey crude oil production. There is no tax burden imposed on out-of-State transactions which is not imposed on the same transactions conducted within the State. This is not a case, for example, where out-of-State depreciation or payroll is not allowed to be deducted while the same in-State expenses are allowed as deductions. The disallowance of the WPT deduction by New Jersey does not result in economic protectionism.

Appellants claim that New Jersey has singled out for special tax burdens a business activity that is conducted only in other states. They claim that they are "subjected to disproportionate tax levies solely on account of their business activities elsewhere." (Appellants' Brief at 44). There is no evidence in the record to support the claim of "disproportionate tax levies." None of Appellants' intrastate marketing competitors have the financial advantages of being an integrated producer-marketer "which

benefits from an umbrella of centralized management and controlled interaction." *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 224 (1980). It is likely that, even with the disallowance of a WPT deduction, Appellants' expenses connected with doing business in New Jersey are less than the expenses of intrastate nonproducer-marketers. After all, the nonproducer-marketers must purchase their products from producers who are going to charge the nonproducers an amount sufficient to return a profit. Also, the producers are the ones who benefit from the extra profits due to decontrol. There is no reason to believe that the New Jersey CBT increases interstate marketers' cost of doing business in New Jersey over that of intrastate marketers or imposes a disproportionate tax burden on the interstate producer-marketers. The tax burden may well be greater for the nonproducer-marketers.

Contrary to Appellants' assertion, they are not denied the deduction for the WPT "solely on account of their business activities elsewhere." (Appellants' Brief at 44). They are not denied a deduction for the WPT because they are engaged in interstate commerce or because they are out-of-State companies. The nonproducer-marketers who sell petroleum products in New Jersey are not necessarily purely local businesses but may also be engaged in interstate commerce. The denial of a deduction for the WPT is not based upon the interstate nature of Appellants' businesses and does not burden out-of-State companies, consumers, or transactions while favoring similar in-State activities. The distinction is between producers and nonproducers, and not between interstate and intrastate marketers. No corporation which is denied a deduction for the WPT is denied such deduction because it

engages in interstate commerce, but because it produces crude oil and pays the federally imposed WPT. If Appellants were interstate marketers which were not also producers of the oil they market, they would not be affected by the disallowance of a WPT deduction. Furthermore, as discussed above, the WPT is not related solely to out-of-State activities but is related to Appellants' marketing activities in New Jersey.

Appellants' argument regarding discrimination against interstate commerce is based upon the false premise that, since there is no crude oil production in New Jersey, there could be no New Jersey intrastate marketer corporation which incurs WPT. However, the federal WPT law imposes the WPT on any "holder of the economic interest with respect to the crude oil", i.e., those entitled to income from lifting the oil who thereby received financial benefits from decontrol through higher prices for their crude oil. 26 U.S.C. § 4996(a). The WPT is, thus, imposed upon the New Jersey lessor of out-of-State oil production wells.[4] Nothing precludes an intrastate corporate marketer from holding such an economic interest and therefore being an oil "producer" as defined in the WPT Act. Such an intrastate marketer would also be denied a WPT deduction for CBT purposes.

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[4]A New Jersey lessor of an out-of-State oil well can be an intrastate marketer because a lessor need not receive the crude oil or even be involved with oil production. The production and ultimate disposal of the oil, under these circumstances, is by the lessee. The lessor receives royalties as a result of production. Nevertheless, the WPT is imposed upon the lessor.

?. Appellants further complain that intrastate mark... who purchase their oil products from integrated oil producers are allowed to deduct their full cost of goods sold, which *may* include a WPT element, while integrated oil producers are not allowed to deduct the WPT. However, this is also true of *interstate* marketers who purchase oil products from integrated oil producers. They may also deduct any WPT element which is passed on to them in the sales price of the goods they purchase and, therefore, is in their cost of goods sold. Whether the WPT is nondeductible or excluded in the cost of goods sold of a taxpayer, for New Jersey CBT purposes, is wholly unrelated to whether the taxpayer is engaged in interstate commerce.[5]

Moreover, the WPT is not imposed on marketers with respect to oil products purchased from integrated oil producers. The WPT is imposed upon the oil producers. All marketers are entitled to exclude from their gross incomes their cost of purchasing oil. That cost contains many elements that integrated oil producers may choose to include or to "pass on" to their customers. When integrated oil producers, such as Appellants, purchase oil from others who pay the WPT and if the purchase price

[5]Unlike other Amici States, Iowa makes a distinction on the basis of whether the producer included the WPT in its inventory costs under 26 U.S.C. § 471 and Treas. Reg. § 1.471-11(c)(2)(iii) on its federal income tax return. *Shell Oil Co. v. Bair,* 417 N.W.2d 425, 428-9 (Iowa 1987). Such distinction is unrelated to the interstate nature of the producer's business. Likewise, those States which do not make the Iowa distinction have not disallowed the WPT deduction on the basis of interstate criteria.

of the oil includes a WPT cost element, integrated oil producers are likewise allowed, for New Jersey CBT purposes, to exclude such purchase price from gross income.

The illustration set forth at pages 45-46 of Appellants' brief fails in its attempt to show that integrated oil producers are taxed more heavily than the independent marketers with which they compete. First, as discussed above, the nonproducer's cost of goods sold will likely be greater than that of the producer, since the producer-marketer will charge the nonproducer-marketer enough to make a profit on the sale. Second, the tax burdens should not be compared "per barrel of product sold in New Jersey" (Appellants' brief at 46), but based upon income attributable to New Jersey. The groups being compared are not taxed on barrels of oil sold in the State but on *income*. Contrary to Appellants' speculative assertions, there is no proof that producer-marketers are at a "material economic disadvantage", bear a "higher effective tax cost" than the independent marketers, or pay more than their "just share." (Appellants' Brief at 45, 47, 49).

The Commerce Clause is not violated when state taxation affects a particular form of business organization, as long as any distinction is not based upon the in-State or out-of-State nature of the organization. In *Exxon Corp. v. Governor of Maryland,* 437 U.S. 117 (1978), the Court held that a Maryland statute did not discriminate against interstate commerce in prohibiting the operation of gasoline stations by companies which refined or produced crude oil. Since no oil was produced or refined in Maryland, the statute prevented integrated oil producer-marketers from operating their own gasoline stations in

the state while leaving gasoline stations operated by non-integrated marketers unaffected. The Court pointed out that the distinction was not between in-State and out-of-State marketers, because several of the independent retailers were in fact interstate marketers:

> As the record shows, there are several major interstate marketers of petroleum that own and operate their own retail gasoline stations. These interstate dealers, who compete directly with the Maryland independent dealers, are not affected by the Act because they do not refine or produce gasoline. In fact, the Act creates no barriers whatsoever against interstate independent dealers; it does not prohibit the flow of interstate goods, place added costs upon them, or distinguish between in-state and out-of-state companies in the retail market. The absence of any of these factors fully distinguishes this case from those in which a State has been found to have discriminated against interstate commerce. *See, e.g., Hunt v. Washington Apple Advertising Comm'n,* 432 U.S. 333, 53 L.Ed.2d 383, 97 S.Ct. 2434; *Dean Milk Co. v. Madison,* 340 U.S. 349, 95 L.Ed. 329, 71 S.Ct. 295. For instance, the Court in *Hunt* noted that the challenged state statute raised the cost of business for out-of-state dealers, and, in various other ways, favored the in-state dealer in the local market. 432 U.S., at 351-352, 53 L.Ed.2d 383, 97 S.Ct. 2434. No comparable claim can be made here. While the refiners will no longer enjoy their same status in the Maryland market, in-state independent dealers will have no competitive advantage over out-of-state dealers. The fact that the burden of a state regulation falls on some interstate companies does not, by itself, establish a claim of discrimination against interstate commerce.

(Footnotes omitted). *Exxon Corp. v. Governor of Maryland,* 437 U.S. at 125-26.

New Jersey treats all corporations upon whom the WPT is imposed exactly alike. This equality of treatment completely forecloses Appellants' interstate commerce discrimination claim.

CONCLUSION

The judgment of the Supreme Court of New Jersey should be affirmed.

Respectfully submitted,

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